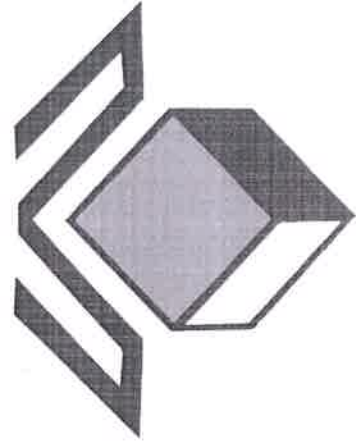


**KHUSHBU**  
AUTO FINANCE LTD.



**ASSET LIABILITY MANAGEMENT POLICY**

Khushbu Auto Finance Limited (KAFL) is a Non-Banking Finance Company registered with Reserve Bank of India (RBI) predominantly engaged in the business of financing of vehicles. KAFL's funding consists of both short term and long term sources with different maturity patterns and varying rates of interest. Its assets are also of varying duration and interest. Hence, maturity mismatches can occur which has an impact on the liquidity and profitability of the company. It is therefore necessary that KAFL constantly monitor and manage its asset and liability in such a manner that asset liability mismatches remain within reasonable limits.

In the normal course of doing business, NBFCs are exposed to credit and market risks in view of the Asset-Liability transformation. With liberalisation in Indian financial markets over the last few years and growing integration of domestic markets with external markets and entry of MNCs for meeting the credit needs of not only the corporates but also the retail segments, the risks associated with NBFCs' operations have become complex and large, requiring strategic management. NBFCs are now operating in a fairly deregulated environment and are required to determine on their own interest rates on deposits, subject to the ceiling of maximum rate of interest on deposits they can offer on deposits prescribed by the Bank; and advances on a dynamic basis. The interest rates on investments of NBFCs in government and other securities are also now market related.

1. Intense competition for business involving both the asset and liabilities has brought pressure on NBFC's to maintain a good balance among spreads, profitability and long term viability. Imprudent liquidity management can put NBFC earnings and reputation at great risk. This pressure call for structured and comprehensive measures and not just ad hoc action. The management of NBFC's have to base their business decisions on dynamic and integrated management system and process driven by corporate strategy. NBFC's are exposed to several measure risk in the course of their business- credit risk, interest rate risk, equity/ commodity price risk, liquidity price risk, liquidity risk, operational risk. It is therefore important that NBFC's introduce effective management system that addresses the issues relating to interest rate and liquidity risk.
2. NBFC's need to address these risks in structured manner by upgrading their risk management and adopting more comprehensive Asset Liability Management (ALM) practices that has been done hereto. ALM among other functions, is also concerned with risk management and provides comprehensive and dynamic framework for measuring, monitoring and managing liquidity and interest rate equity and commodity price risks of major operators in the financial system that needs to be closely integrated with the NBFCs' business strategy. It involves assessment of various types of risks and altering the asset-liability portfolio in a dynamic way in order to manage risks.
3. Having understood the significance of sound ALM practices KAFL proposed to lays down broad guidelines in respect of interest rate and liquidity risks management systems in company, which forms part of the Asset-Liability Management (ALM) function. The initial focus of the ALM function would be to enforce the risk management discipline i.e. managing business after assessing the risks involved. The objective of good risk management systems should be that these systems will evolve into a strategic tool for KAFL's management.



4. The ALM process rests on three pillars:

- ALM Information Systems
  - => Management Information Systems
  - => Information availability, accuracy, adequacy and expediency
- ALM Organisation
  - => Structure and responsibilities
  - => Level of top management involvement
- ALM Process
  - => Risk parameters
  - => Risk identification
  - => Risk measurement
  - => Risk management
  - => Risk policies and tolerance levels.

5. ALM information Systems

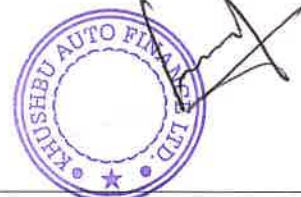
ALM has to be supported by a management philosophy which clearly specifies the risk policies and tolerance limits. This framework needs to be built on sound methodology with necessary information system as back up. Thus, information is the key to the ALM process.

There are various methods prevalent world-wide for measuring risks. These range from the simple Gap Statement to extremely sophisticate and data intensive Risk Adjusted Profitability Measurement methods.

However, Through the central element for the entire ALM exercise is the availability of adequate and accurate information with expedience; and the systems existing. Adequate measures are to be taken to collect accurate data in a timely manner through full scale computerization

6. ALM Organisation

- 6.1. (a) Successful implementation of the risk management process would require strong commitment on the part of the senior management in the company, to integrate basic operations and strategic decision making with risk management. The Board of Directors lead by Chairman and Managing Director will have overall responsibility for management of risks and should decide the risk management policy of the NBFC and set limits for liquidity, interest rate and equity price risks.



(b) The Asset - Liability Committee (ALCO) consisting of following members should be responsible for ensuring adherence to the limits set by the Board as well as for deciding the business strategy of the company (on the assets and liabilities sides) in line with the company's budget and decided risk management objectives.

1. Mr. Hiren V Patel, Director
2. Mr. Harish J Chandra, Director

(c) The ALM Support Groups consisting of operating staff should be responsible for analysing, monitoring and reporting the risk profiles to the ALCO. The staff should also prepare forecasts (simulations) showing the effects of various possible changes in market conditions related to the balance sheet and recommend the action needed to adhere to Company's internal limits.

6.2. The ALCO is a decision making unit responsible for balance sheet planning from risk return perspective including the strategic management of interest rate and liquidity risks. The business and risk management strategy of the company will ensure that the company operates within the limits / parameters set by the Board. The business issues that an ALCO would consider, inter alia, will include product pricing for both deposits and advances, desired maturity profile and mix of the incremental assets and liabilities, prevailing interest rates offered by other peer NBFCs for the similar services/product, etc. In addition to monitoring the risk levels of the company, the ALCO should review the results of and progress in implementation of the decisions made in the previous meetings. The ALCO would also articulate the current interest rate view of the company and base its decisions for future business strategy on this view, In respect of the funding policy, for instance, its responsibility would be to decide on source and mix of liabilities or sale of assets. Towards this end, it will have to develop a view on future direction of interest rate movements and decide on funding mixes between fixed v/s floating rate funds, wholesale v/s retail deposits, money market v/s capital market funding, domestic v/s foreign currency funding, etc.

The frequency of holding their ALCO meetings will be bi-monthly. However, if the need be for a meeting at a short notice, the ALCO meet at a shorter notice.

### 6.3. Board of Directors Meetings and Review

The Board of Directors, in their board meetings, will oversee the implementation of the system and review its functioning periodically.

## 7. ALM Process:

The scope of ALM function can be described as follows:

- Liquidity risk management



- Management of market risks
- Funding and capital planning
- Profit planning and growth projection
- Forecasting and analyzing 'What if scenario' and preparation of contingency plans

The guidelines given in this note mainly address Liquidity and Interest Rate risks.

## 8. Liquidity Risk Management

8.1. Measuring and managing liquidity needs are vital for effective operation of company. The importance of liquidity transcends individual institutions, as liquidity shortfall in one institution can have repercussions on the entire system. ALCO should measure not only the liquidity positions of company on an ongoing basis but also examine how liquidity requirements are likely to evolve under different assumptions. Experience shows that assets commonly considered as liquid, like Government securities and other money market instruments, could also become illiquid when the market and players are unidirectional. Therefore, liquidity has to be tracked through maturity or cash flow mismatches. For measuring and managing net funding requirements, the use of a maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates is adopted as a standard tool. The format of the Statement of Structural Liquidity as prescribed by Reserve Bank of India (RBI) may be used for this purpose.

8.2. The Maturity Profile based on ALM - II could be used for measuring the future cash flows of company in different time buckets. The time buckets, may be distributed as under:

- I. 1 day to 30/31 days (One month)
- II. Over one month and up to 2 months
- III. Over two months and up to 3 months
- IV. Over 3 months and up to 6 months
- V. Over 6 months and up to 1 year
- VI. Over 1 year and up to 3 years
- VII. Over 3 years and up to 5 years
- VIII. Over 5 years

8.3. As KAFL does not hold public deposits, all the investment securities would fall in the category of 'non-mandatory securities'. All non - mandatory securities may be kept in buckets of future time frame for the purpose of determining their cash flows based on maturity of such security and intention of holding such security till the time of such maturity.

Alternatively, the company may also follow the concept of Trading Book which is as follows:

- I. The composition and volume are clearly defined;
- II. Maximum maturity/duration of the portfolio is restricted;



- III. The holding period not to exceed 90 days;
- IV. Cut-loss limit prescribed;
- V. Defeasance periods (product-wise) i.e. time taken to liquidate the position on the basis of Liquidity in the secondary market is prescribed;

When company proposed to maintain such 'Trading Books' and complying with the above standards may show the trading securities under "1 day to 30/31 days (One month)", "Over one month and up to 2 months" and "Over two months and up to 3 months" buckets on the basis of the defeasance periods. The Board/A LCO of the company should approve the volume, composition, holding/defeasance period, cut loss, etc. or the 'Trading Book'. The remaining investments should also be classified as short term and long term investments as required under Prudential norms.

8.4. The policy note recorded by the company on treatment of the investment portfolio for the purpose of ALM and approved by their Board/ALCO should be forwarded to the Regional Office of the Department of Non-Banking Supervision of RBI under whose jurisdiction the registered office of the company is located

8.5. Within each time bucket, there could be mismatches depending on cash inflows and outflows. While the mismatches up to one year would be relevant since these provide early warning signals of impending liquidity problems. the main focus should be on the short-term mismatches viz.. 1-30/31 days. Company, however, is expected to monitor its cumulative mismatches (running total) across all time buckets by establishing internal prudential limits with the approval of the ALCO. The mismatches (negative gap) during 1- 30/31 days in normal course may not exceed 15% of the cash outflows in this time bucket.

8.6. The Statement of Structural Liquidity shall be prepared by placing all cash inflows and outflows in the maturity ladder according to the expected timing of cash flows. A maturing liability will be a cash outflow while a maturing asset will be a cash inflow. While determining the likely cash inflows and outflows, company have to make a number of assumptions according to their asset - liability profiles. While determining the tolerance levels, the company may take into account all relevant factors based on their asset-liability base. Nature of business, future strategy etc.

8.7. In order to enable the company to monitor their short-term liquidity on a dynamic basis over a time horizon spanning from 1 day to 6 months, company will estimate their short-term liquidity profiles on the basis of business projections and other commitments for planning purposes. An indicative format ALM -1 issued by RBI for estimating Short-term Dynamic Liquidity will be used for the said purpose.

## 9. Currency Risk

The company does not have any currency risk as of now as there are no transactions entered by the company which will involve currency risk. However, in future, if such transactions are entered into, the



company will take appropriate steps to modify this policy and incorporate measures to check currency risk.

#### 10. Interest Rate Risk (IRR)

10.1. The operational flexibility given to NBFCs in pricing most of the assets and liabilities imply the need for the financial system to hedge the interest Rate Risk. Interest rate risk is the risk where changes in market interest rates might adversely affect an NBFC's financial condition. The changes in interest rates affect company in some way. The immediate impact of changes in interest rates is on company's earnings (i.e. reported profits) by changing its Net Interest Income (NII). As such KAFL is into funding of loans which are always fixed rate loans. The loans borrowed from banks are mostly at floating rates. The company manages this risk on NII by pricing its loan products to customers at a rate which covers interest rate risk. The risk from the earnings perspective can be measured as changes in the Net Interest Income (NII) or Net Interest margin (NIM). Measurement of such risk is done at the time of deciding rates to be offered to customers. Once interest rate risk is measured by the ALCO, lending rates are finalized. RBI has prescribed ALM -III for the purpose of Interest Rate Risk Monitoring and company may use the same for the purpose of measurement and monitoring of interest rate risk.

